IN THE

Supreme Court of the United States

OCTOBER TERM, 1977

No. 77-1171

ERNEST LATHROP AND MARY D. LATHROP, INDIVIDUALLY AND AS REPRESENTATIVES OF ALL PERSONS SIMILARLY SITUATED,

Petitioners,

vs.

BELL FEDERAL SAVINGS & LOAN ASSOCIATION, A CORPORATION ORGANIZED AND EXISTING UNDER THE LAWS OF THE UNITED STATES,

Respondent.

BRIEF OF BELL FEDERAL SAVINGS AND LOAN ASSOCIATION IN OPPOSITION TO PETITION FOR WRIT OF CERTIORARI.

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SUPPLEMENTAL CONTROLLING FEDERAL REGULATIONS.

1. Federal Housing Authority Regulations:

(a) 24 C. F. R. § 203.7:

"(a) Approval of a mortgagee may be withdrawn at any time by notice from the Commissioner, by reason of.

(1) The transfer of an insured mortgage to a non-approved mortgagee except pursuant to § 203.433 or § 203.435 of this part;

(2) The failure of a non-supervised mortgagee to segregate all escrow funds received from mortgagors on account of ground rents, taxes, assessments and insurance premiums, and to deposit such funds to a special account or accounts with a financial institution whose accounts are insured by the Federal Deposit Insurance Corporation or by the Federal Savings and Loan Insurance Corporation;

(3) The use of escrow funds for any purpose other than that for which they were received;

(4) The failure of a non-supervised mortgagee to conduct its business in accordance with the plan indicated by its application for approval;

(5) The termination of a mortgagee's supervision by a governmental agency;

(5a) The failure of a non-supervised mortgagee or an investing mortgagee to submit the required annual audit report of its financial condition within 75 days of the close of its fiscal year or such longer period as the Commissioner may determine.

(6) The payment by the mortgagee of any fee, kickback, or other consideration, directly or indirectly, in connection with any insured mortgage transaction or transactions to any person including an attorney, escrow agent, title company, consultant, mortgage broker, seller, builder, or real estate agent if such person has received any other payment or other consideration from the mortgagor, the seller, the builder, or any other person for services related to such transaction or transactions or from or related to the purchase or sale of the mortgaged property, except that compensation may be paid for the actual performance of such services as may be approved by the Commissioner.

(7) Such other reason as the Commissioner determines to be justified.

(b) Withdrawal of a mortgagee's approval shall not affect the insurance on mortgages accepted for insurance."

(b) 24 C. F. R. § 203.4:

"(b) Special requirements applicable to supervised institutions. A mortgagee approved as a supervised institution shall meet these requirements:

(1) The mortgagee shall be subject to the inspection and supervision of a governmental agency which is required by law to make periodic examinations of the mortgagee's books and accounts.

(2) The mortgagee shall submit satisfactory evidence of certain sound capital funds or, if it is a mutual company or association without capital funds, it shall show that it has a specified net worth. The required amount of capital funds or net worth shall be determined in the following manner:

(i) With respect to a mortgage whose application was filed and approved on or before March 1, 1962, capital funds or net worth of a value of not less than $25,000.

(ii) With respect to a mortgagee whose application for approval was filed on or before March 1, 1962, but not approved until subsequent to such date, capital funds or net worth of a value of not less than $25,000, provided that such amount shall be increased to a value of not less than $100,000 on or before December 31, 1962.

(iii) With respect to a mortgagee filing an application for approval subsequent to March 1, 1962, capital funds or net worth of a value of not less than $100,000.

(c) Special requirements—non-supervised institutions: A mortgagee not subject to inspection and supervision of a governmental agency as provided in the preceding paragraph shall have as its principal activity the lending or investment of funds under its own control in real estate mortgages; shall have sound capital funds of a value of not less than $100,000; shall submit a detailed audit of its books made by an account satisfactory to the Commissioner, reflecting a condition satisfactory to him; shall file with the Commissioner similar audits

within 75 days of the close of its fiscal year so long as its approval as mortgagee continues; shall submit at any time to such examination of its books and affairs as the Commissioner may require; and shall comply with any other conditions that the Commissioner may impose. Prior to the approval of any such mortgagee, it shall submit an agreement in writing:

(1) [Reserved]

(2) That, except with the prior approval of the Commissioner, it will segregate escrow commitment deposits, work completion deposits, and all periodic payments under mortgages insured by the Commissioner, received by it on account of ground rents, taxes, assessments and insurance premiums, and will deposit such funds in a special account or accounts with a financial institution whose accounts are insured by the Federal Deposit Insurance Corporation or by the Federal Savings and Loan Insurance Corporation and shall use such funds for no purpose other than that for which they were received."

2. Federal Savings and Loan System Regulations:

12 C. F. R. § 545.6-11(c):

(c) Payment of interest on escrow accounts. A Federal association which makes a loan on or after June 16, 1975 on the security of a single-family occupied or to be occupied by the borrower (except such a loan for which a bona fide commitment was made before that date) shall pay interest on any escrow account maintained in connection with such a loan (1) if there is in effect a specific statutory provision or provisions of the State in which such dwelling is located by or under which State-chartered savings and loan associations, mutual savings banks and similar institutions are generally required to pay interest on such escrow accounts, and (2) at not less than the rate required to be paid by such State-chartered institutions but not to exceed the rate being paid by the Federal association in its regular accounts (as defined in § 526.1 of this chapter). Except as provided by contract, a

Federal association shall have no obligation to pay interest on escrow accounts apart from the duties imposed by this paragraph.

ARGUMENT.

A Writ of Certiorari Should Not Be Granted Where the Illinois Supreme Court Has Correctly Interpreted the Controlling Federal Regulations and Where the State Court Relied Principally on State Law in Reaching Its Decision.

A. There Is No Adequate Jurisdiction Basis for This Court to Exercise Its Discretionary Certiorari Jurisdiction.

Petitioner invokes the jurisdiction of this Court under Title 28, United States Code, Section 1257(3) by contending both in his questions for review and in the body of his argument that the decision of the Illinois Supreme Court frustrates the application of the National Housing Act of 1934 and the regulations of the Federal Housing Authority (FHA) promulgated pursuant thereto, thus raising an issue of national importance. Respondent submits first that an examination of the applicable regulations will show the fallacy of such assertions thereby eliminating any purported issue of national importance.

Initially, it must be pointed out that the FHA regulations (24 C. F. R. § 203.1 *et seq.*) establish a dichotomy between non-supervised lending institutions and supervised lending institutions. Pursuant to Section 203.4 thereof, respondent is classified as a supervised institution since it is subject to the inspection and control of governmental agencies, such as the Federal Home Loan Bank Board and the Federal Savings and Loan Insurance Corporation. The requirements imposed upon non-supervised institutions differ markedly from those imposed (or not imposed) on supervised institutions. 24 C. F. R. § 203.4(c)(2) requires that a non-supervised institution must segregate advanced payments for taxes and insurance premiums and deposit such payments in special accounts. There is no like provision for supervised institutions. Similarly, 24 C. F. R. § 203.7(a)(2)

provides that if a non-supervised motgagee fails to segregate such payments and fails to deposit them in a special account, the approval may be withdrawn. Again, there is no like provision for supervised institutions. If the interpretation petitioner seeks to attach to 24 C. F. R. § 203.7(a)(3) were valid, sub-paragraph (2) thereof would be mere verbiage; and there would be no need for its inclusion in the regulation. The doctrine of *Expressio Unius Est Exclusio Alternis* is applicable in this regard in that, when construing a statute, the enumeration of certain things in a statute implies the exclusion of all others. Petitioner's interpretation of 24 C. F. R. § 203.7(a)(3) was also rejected in *Gilson* v. *First Federal Savings and Loan Association,* 364 F. Supp. 614 (U. S. D. C., Mich. 1973) wherein the court stated at page 616: "Plainly First Federal is 'supervised' and thus not required by 24 C. F. R. Section 203.7(a)(2) to segregate. There is no regulation requiring First Federal to segregate."

Moreover, in 1975, the Federal Home Loan Bank Board (Board) acting under power delegated by Congress through 12 U. S. C. 1464(a), promulgated 12 C. F. R. 545.6-11(c), which in pertinent part states that on certain loans made on or after July 16, 1975, a Federal association shall pay interest on the escrow account if there is in effect a specific state statutory provision for such, and that, "except as provided by contract, a Federal association shall have no obligation to pay interest on escrow accounts apart from the duties imposed by this paragraph." The cited regulation clearly indicates that federal associations (supervised institutions) have no obligation to pay interest on escrow accounts unless provided by contract or state statute.

In a February 22, 1978 decision, the United States District Court of Massachusetts had occasion to interpret the meaning of the above regulation in the case of *Greenwald* v. *First Federal Savings and Loan Association,* Civil Nos. 76-3931-C and 77-76-C (Consolidated) (D. Mass., February 22, 1978). The main

issue of the case was whether the federal laws and regulations preempted the field of interest payments on escrow accounts by federally chartered savings and loan associations. The cited court held that preemption did occur and ergo the Massachusetts law requiring federal lending institutions to make interest payments on tax assessments based on outstanding loans made prior to June 16, 1975 was in conflict with the Supremacy Clause of the United States Constitution; and thus the federal regulation prevailed. Both the above cited FHA regulations, the Board regulation, and the *Greenwald* decision show that the supervised federal savings and loan association such as respondent is not required by any federal law or regulation to pay interest on escrow accounts in the mortgage-lending situation now before the Court. To be sure, the applicable regulations and case law indicate that the intent of the governing federal regulatory agencies is that such lending institutions should not pay interest on such accounts unless required to do so by contract or appropriate state law.

B. The Applicable State Law Is Determinative of the Issues Involved.

In reference to the state law controlling in the instant case, the Illinois Supreme Court held that neither was there an express trust created by the terms of the mortgage; nor were there sufficient facts alleged to show the creation of a fiduciary relationship or the breach thereof justifying the imposition of a constructive trust. The cited court therefore found that on the basis of neither federal law nor state law was the respondent required to pay interest on the escrow accounts. Additionally, although petitioner begins his argument by representing to this Court that the instant case is a class action (Pet. Cert. 8.), the issue of whether the suit is properly a class action was never determined in the state court. Where the Illinois Supreme Court has not only correctly interpreted the intent of the applicable federal regulations, consistent with the other state and federal courts

which have decided similar issues, but also where the State Supreme Court has properly decided the issues on the basis of state contract and trust law, respondent submits that this Court should not exercise its discretionary certiorari jurisdiction, since such issues are more appropriately decided at the state court level.

C. The FHA Guidelines Cited by Petitioner Are Mere Statements of Policy.

Petitioner has also cited certain guidelines from the FHA Mortgagee's Guide Book (FHA § 4015.19, 1-4a) asserting that the cited guidelines are raised to the level of law in that such guidelines express the FHA's interpretation of its own regulations. There are two problems with such a proposition, the first of which is indicated by petitioner's reference to such guidelines as "Interpretative Rules" on page seven of the petition. Petitioner apparently has no conception of the distinction between administrative rules enacted in accordance with the Administrative Procedure Act and guidelines or booklets issued by the various administrative agencies. In a memorandum filed in *Brown* v. *Lynn*, 392 F. Supp. 559 (U. S. D. C. N. D. Ill. 1975), James T. Lynn, Secretary of the United States Department of Housing and Urban Development, stated with respect to the FHA Guides cited by the petitioner herein:

> "As far as the mortgagee's guide lines are concerned, it is clear that the statements therein are statements of policy, are not issued pursuant to the Administrative Procedure Act, and do not have the force and effect of law . . . they have no binding effect on the mortgagee. . . ." (R. C277.)

This Court has also noted the distinction in *Thorpe* v. *Housing Authority*, 393 U. S. 268 (1968) wherein it was held that the requirements of a certain HUD circular were mandatory in contrast to the various handbooks and booklets issued by HUD which contain mere instructions, technical suggestions, and items for consideration. Secondly, this Court did state in the case of *Bowles* v. *Seminole Rock Co.*, 325 U. S. 410 (1945)

that administrative interpretation is used to construe an administrative regulation. However, such interpretations are utilized in construction only where there is an ambiguity in the controlling regulation. The instant case involves regulations wherein no ambiguity exists; thus, there is no need to resort to administrative guidelines to determine their meaning.

D. Petitioner Has Inaccurately Represented the Rationale Both of the Illinois Supreme Court and of the Courts Which Have Decided Similar Issues.

In attempting to make his argument more palatable to this Court, petitioner has inaccurately referred to both the findings of the Illinois Supreme Court in the instant case and also two cases cited by said court. First, petitioner states that the "Illinois Supreme Court relied principally on two cases which are not actually dispositive of the question or supportive of the court's determination. . . ." (Pet. Cert. 9.) The following quotation from the Illinois Supreme Court's opinion indicates the error of petitioner's statement:

> "It is worth noting that many cases involving similar questions have been presented to the courts of this State and country in the last decade. Because of the differences in the specific language of the mortgage contracts and because of the different posture of the cases on the pleadings and on appeal, we deem none of them dispositive of the issues herein." (Pet. Cert. A-2.)

Likewise on page nine of his brief, petitioner contends that the Michigan court's determination in *Gibson* v. *First Federal Savings and Loan Association of Detroit*, 504 F. 2d 826 (6th Cir. 1974) that there is no FHA regulation prohibiting the use of escrow funds for investment is contrary to 24 C. F. R. 203.7 (a)(3) which subjects a mortgagee to the risk of withdrawal of FHA approval if escrow funds are used for purposes other than for which they were received. Such a statement totally ignores the cited court's rationale that investment of escrow accounts

between collection and payment is proper so long as such funds are not used for purposes other than payment of taxes and insurance premiums. In a footnote to its opinion, the Michigan court indicated that by implication, investment of such funds may even be required by supervised institutions since non-supervised institutions are specifically required to deposit such funds into insured financial institutions.

Petitioner also misconstrues *Brooks* v. *Valley National Bank*, 113 Ariz. 169, 548 P. 2d 116 (1976) by asserting that the case was decided on the basis of custom and usage. Actually, in reaching its decision, the cited court referred to the Second Restatement on Trusts wherein custom and usage in similar transactions is one of seven elements utilized to determine the intention of the parties as to whether the payment of money creates a debt or a trust. Relying on these seven elements, the cited court held that no trust was created where the mortgagor did not claim that he intended such payments to be held in trust and where the mortgagee specifically denied the creation of a trust relationship. However, in the concurring opinion to the *Brooks* decision, the Vice Chief Justice did hold that a trust was created by the contract between the parties; but the opinion went on to state that where the custom since the early 1930's was that the lending institution did not pay interest for the use of impound funds, it can be said that the parties contracted with reference to it and failure to conform to it would be the exception. Therefore, the Vice Chief Justice concluded that neither interest nor earnings on investment was expected to be credited to the mortgagor.

E. Petitioner's Supportive Cases Do Not Stand for the Principle Conferred Upon Them.

Petitioner concludes his first argument by citing a list of cases purportedly standing for the proposition "that the phrase 'in trust' in the FHA mortgage creates an express trust with all consequences thereof. . . ." (Pet. Cert. 10.) A brief review of the cited

cases will demonstrate that this assertion is patently false. As a side note, it is pointed out that petitioner also contends that none of the cases cited in *Brooks* v. *Valley National Bank*, 113 Ariz. 169, 548 P. 2d 1166 (1976) involve FHA mortgages. (Pet. Cert. 10.) Yet, in apparent contradiction to this statement, petitioner then cites, in the very next paragraph, three such cases to support his proposition that the words "in trust" in the FHA mortgage create an express trust: *viz.*, *Abrams* v. *Crocker-Citizens National Bank*, 114 Cal. Rptr. 913, 41 Cal. App. 3d 55 (1974); *Carpenter* v. *Suffolk Franklin Savings Bank*, 362 Mass. 770, 291 N. E. 2d 609 (1972); and *Buchanan* v. *Brentwood Federal Savings and Loan Association*, 457 Pa. 135, 320 A. 2d 117 (1974).

Reviewing these supportive cases, in *Abrams* v. *Crocker-Citizens National Bank*, 114 Cal. Rptr. 913, 41 Cal. App. 3d 55 (1974), the lower court had dismissed a class action brought by borrowers for mishandling of escrow account. The cited court held such dismissal was improper where conflicting affidavits were submitted giving rise to a factual issue as to whether the intent to create a trust existed. The facts still had to be proved at the trial court level. Similarly, in *Carpenter* v. *Suffolk Franklin Savings Bank*, 362 Mass. 770, 291 N. E. 2d 609 (1972) the appellate court reversed the lower court's dismissal of an action by mortgagors for an accounting of any profits realized on tax funds. The cited court held that, on the basis of state law, plaintiffs had stated a cause of action requiring a hearing on the merits. Likewise, in *Buchanan* v. *Brentwood Federal Savings and Loan Association*, 457 Pa. 135, 320 A. 2d 117 (1974) the appellate court reversed the lower court's dismissal of an action by mortgagors for an accounting holding that the complaint sufficiently put in issue questions of whether an accounting and constructive trust were appropriate. In all of the above cited cases, the existence of a trust "with all the consequences thereof" was yet to be proven.

In *McGhee* v. *Bank of American National Trust and Savings Association*, 131 Cal. Rptr. 482, 60 Cal. App. 3d 442 (1976), the issue before the appellate court was whether the combined cases could properly be maintained as class actions. The cited court held that plaintiffs must first show that the contracts were contracts of adhesion, which would then allow a class action. Finally, once class status is achieved, the collective intent of the parties could be utilized to show the existence or non-existence of a trust.

The issue in *Richmond Hill Savings Bank* v. *Commissioner*, 57 U. S. Tax Reports 738, 747 (1972) was whether, in determining the reserve for bad debts under section 593(b)(3) of the Internal Revenue Codes of 1954, the mortgagee's stated qualifying real property loans must be reduced by the amount of the escrow funds held. The cited court held that such funds were held for a special purpose and therefore could not reduce the bad debt reserve in computing income. Also, in *Liberty National Insurance Co.* v. *United States*, 463 F. 2d 1027 (5th Cir. 1972), the issue was whether mortgage escrow funds are assets within the meaning of section 805(b)(4) of the Internal Revenue Code of 1954 for purposes of computing the company's taxable investment yield. The cited court held such funds were not assets since such funds were not available to satisfy the company's own obligations. The issue before the court in *Franklin Life Insurance Co.* v. *United States*, U. S. Tax Cases, Vol. 67-2, par. 9515 (U. S. D. C. S. D. Ill. 1967) was also whether escrow funds constitute assets in determining a mortgagee's taxable investment income. Again, the cited court held such funds were not assets of the mortgagee since the mortgagee did not have the use of such funds. Once again, in the above three tax cases, all the consequences of an express trust were not imputed to the mortgagees holding escrow accounts, as petitioner asserts.

Additionally, *Boyce* v. *National Commerical Bank & Trust Co. of Albany*, 247 N. Y. S. 2d 521 (1964) was a suit for fire

loss against the insurer and mortgagee bank which held escrow funds to pay premiums to the insurer. In holding the mortgagee bank not liable for the fire loss, the cited court stated that the escrow payments were made to guarantee the existence of a fund from which to pay insurance and taxes; and such escrow payments did not make the mortgagee bank a trustee for the mortgagor's benefit. Obviously, petitioner has again distorted the principles enunciated by the court; and, as has been shown, petitioner has no legal support for the proposition being proffered to this Court.

CONCLUSION.

For the reasons set forth above, the petition for certiorari should be denied.

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